Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Person to Contact:

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Attn:

LEGEND:

State A =
Employer M =
Plan X =

Ladies and Gentlemen:

Introductory paragraphs

This is in response to a request submitted on your behalf by your authorized representative on May 28, 1998, for a private ruling letter concerning the federal income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

Facts

In support of the ruling request the following facts and representations have been submitted:

The law of State A provides that a municipality shall establish and administer a police pension plan, funded in part by mandatory employee contributions, and that the municipality may pick up the policemen's contributions. On March 12, 1998, Employer M, a municipality under the law of State A, adopted a resolution, effective May 1, 1998, providing that Employer M shall pick up participants' contributions to Plan X in accordance with the law of State A and that participants' cash salaries shall be reduced by the amount picked up. The resolution specifically indicates that the employee contributions will be paid by Employer M. Participants in Plan X will not be given the option to receive cash directly in lieu of contributions.

Employer M asserts in its ruling request that Plan X meets the qualification requirements of section 401(a) of the Code.

Based on the facts described above, Employer M requests the following rulings under section 414(h) of the Code:

1. The amount picked up by Employer M will not constitute gross income to the employees of Employer M, on whose behalf the pick-up is made;

2. The amount picked up by Employer M will not constitute wages from which Employer M must deduct and withhold a tax in accordance with sections 3401-3404 of the Code; and,

3. The above rulings apply regardless of whether the pick-up is made through a reduction in salary or through an offset against future salary increases or a combination of both.

With respect to the first ruling request, section 414(h)(2) of the Code provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan described in section 401(a) established by a state government or a political subdivision thereof and are picked up by the employing unit.

The federal income tax treatment to be accorded contributions which are picked up by the employer within the meaning of section 414(h)(2) of the Code is specified in Revenue Ruling 77-462, 1977-2 C.B. 358. In that revenue ruling, the employer school district agreed to assume and pay the amounts employees were required by state law to contribute to a state pension plan. Revenue Ruling 77-462 concluded that the school district's picked-up contributions to the plan are excluded from the employees' income until such time as they are distributed to the employees. The revenue ruling held further that under the provisions of section 3401(a)(12)(A), the school district's contributions to the plan are excluded from wages for purposes of the Collection of Income Tax at Source on Wages; therefore, no withholding is required from the employees' salaries with respect to such picked up contributions.

The issue of whether contributions have been picked up by an employer within the meaning of section 414(h)(2) of the Code is addressed in Revenue Ruling 81-35, 1981-1 C.B. 255, and Revenue Ruling 81-36, 1981-1 C.B. 255. These revenue rulings established that the following two criteria must be met: (1) the employer must specify that the contributions, although designated as

employee contributions, are being paid by the employer in lieu of contributions by the employee; and (2) the employee must not be given the option of choosing to receive amounts directly instead of having them paid by the employer to the pension plan. Furthermore, it is immaterial whether an employer picks up contributions through a reduction in salary, an offset against future salary increases, or a combination of both.

In Revenue Ruling 87-10, 1987-1 C. B. 136, the Internal Revenue Service considered whether contributions designated as employee contributions to a governmental plan are excludable from the gross income of the employee. The Service concluded that to satisfy the criteria set forth in Revenue Rulings 81-35 and 81-36 with respect to particular contributions, the required specification of designated employee contributions must be completed before the period to which such contributions relate.

The resolution adopted by Employer M satisfies the criteria set forth in Revenue Rulings 81-35 and 81-36 that (1) the contributions, although designated as employee contributions, are to be made by Employer M in lieu of contributions by the employees, and (2) the employees may not elect to receive such contribution amounts directly.

Accordingly, we conclude that (1) all of the mandatory employee contributions "picked up" by Employer M shall be excluded from the gross income of the participants in the year in which they are made, (2) the "picked up" contributions paid by Employer M are not wages for federal income tax withholding purposes and federal income taxes need not be withheld on the "picked up" contributions, and (3) it is immaterial whether Employer M picks up the contributions through a reduction in salary, an offset against future salary increases, or a combination of both.

The effective date for the commencement of the pickup contributions cannot be earlier than the later of the date the resolution is signed or the date it is put into effect. In this case, the effective date of the resolution is May 1, 1998. Accordingly, the rulings apply only to contributions picked up on or after May 1, 1998.

This ruling is based on the assumption that Plan X will be qualified under section 401(a) of the Code at the time of the picked-up contributions. No opinion is expressed as to whether the amounts in question are subject to tax under the Federal Insurance Contributions Act. No opinion is expressed as to whether the amounts in question are being paid pursuant to a

"salary reduction agreement" within the meaning of section 3121(v)(1)(B).

A copy of this letter is being sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely yours,

John Swieca
Chief, Employee Plans
Technical Branch 1

Enclosures:
Deleted copy
Notice of Intention to Disclose

cc:

cc: